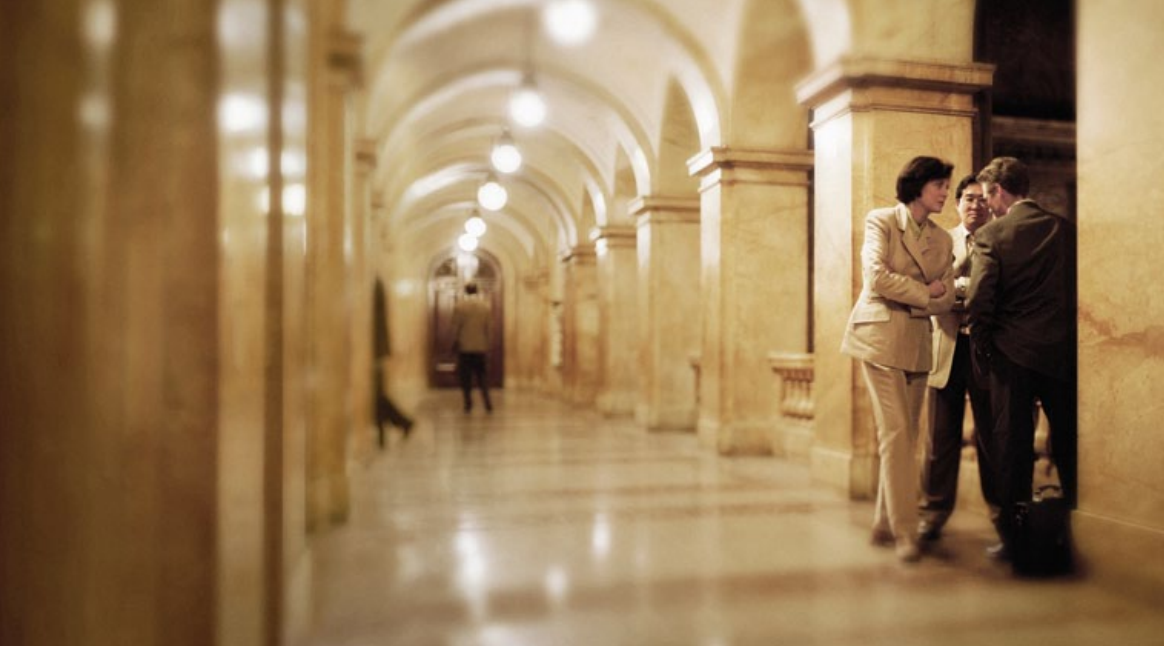

LINE OF SIGHT

CHANGING CONVERSATIONS:

LONG-TERM TRUST DESIGN – DRAFTING FOR THE LONG HAUL

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The fourth in our "Changing Conversations" series of articles on values-driven estate planning.

Since the implementation of the Generation Skipping Transfer (GST) tax, many advisors have designed long-term trusts in order to utilize an individual's GST exemption. Even individuals of relatively modest means have provisions in their documents allowing the GST exemption to be allocated, thereby ensuring the creation of trusts that are wholly exempt or non-exempt for GST purposes. While some states favor eliminating the standard Rule Against Perpetuities, and others choose to extend it, the outcome is the same: to permit trusts that last hundreds of years, or even forever.

The challenge in drafting such trusts, however, is precisely what makes them attractive – they could last forever. It is impossible to know how the circumstances surrounding the trust – the legal and tax environment, the status of the beneficiaries, the financial stability of the assets and even new-and-never-considered challenges of the future – will change over the course of time. As advisors, this uncertainty requires a new level of flexibility, as well as additional consideration regarding how best to craft a plan that can bend to meet these changes, but maintains as its backbone the grantor's values and goals. It also highlights the importance of striking the delicate balance between flexibility, grantor intent and fulfilling a client's multi-generational wealth transfer goals.

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THE CHANGING FACE OF THE AMERICAN FAMILY

One of the most significant changes in American society over the past 25 years has been the evolution of the American family. Far fewer families are of the traditional, two-parent-and-biological-children household variety. Blended families, single-parent households and LGBT (lesbian, gay, bisexual and transgender) families are more common than ever before. These changing demographics will impact how trusts are drafted, and accordingly, how they function.

Because long-term trusts are designed to last for multiple generations, it is virtually impossible to know what each family ultimately will look like in the future. As a consequence, the traditional definition of descendants may not be sufficiently flexible. In the past, that definition often read:

In determining whether any person is a child or descendant for purposes of this agreement, children and descendants by both birth and adoption shall be included, except that:

(a) a person adopted when over the age of 18 years shall be excluded,

(b) a person born out of wedlock shall be treated as the child of the mother, unless her parental rights are terminated by placement for adoption or otherwise, and

(c) a person born out of wedlock shall not be treated as a child of the father unless the father marries the mother, acknowledges paternity of the child by a writing delivered to the trustee during the father's lifetime or paternity is established by adjudication before or after the death of the father.

This definition reflects a traditional family structure, in which all children are the descendants of both parents, born in a traditional manner following a traditional marriage. However, it fails to consider the evolution of today's modern family. Clearly, in many current estate plans, this definition will need to be revised and updated to reflect the times.

The other significant impact of the changing face of families is the increased likelihood of disconnection and disharmony.

The other significant impact of the changing face of families is the increased likelihood of disconnection and disharmony. The ability for the family to work through problems without outside intervention may be significantly reduced when a family incorporates individuals who are related only through one parent, or where the relationship is complicated because of multiple marriages, divorces or disagreements in the past. The increased likelihood of infighting and conflict also will likely lead to more litigation over the terms of the estate plan, with allegations of undue influence, unfairness, lack of capacity, interference with an expectancy and other accusations of wrongdoing becoming ever more common.

DOCUMENT, DOCUMENT, DOCUMENT

Consequently, as trusted advisors, we will need to consider additional safeguards when drafting and executing estate plans. The potential for increased cost of administering long-term trusts after a death because of the potential or actual conflict that may result also will be a consideration. One of the steps we might consider is increasing the gathering of supplemental documentation, in the forms of contemporaneous notes and letters, regarding the discussions surrounding and reasons behind the various estate planning choices made. In addition, the inclusion of *in terrorem* clauses should be discussed with the grantor. While many courts are reluctant to enforce such clauses on public policy grounds, their inclusion, particularly when coupled with a bequest of some size that would be lost if there is a contest, can be a very compelling deterrent to litigation. Documentation of competency and comprehension of the terms of the estate plan, via medical reports and other third-party reporting also can be very helpful. Some advisors prefer to videotape the execution of the estate plan as well, which may be helpful if everything goes perfectly. However, one poorly worded comment by the grantor may open the door to litigation that would otherwise have no basis, making this option one to be carefully considered before it is used.

Lastly, there is a very practical consequence to these changes in the American family for drafters – a detailed discussion with the grantor as to his or her plans and intentions now is required. Who constitutes family? Should different types of family members receive different benefits? A client's answers to these questions need to be incorporated directly into the documents, ensuring that the grantor's intentions on this issue are clear, respected and memorialized for future generations. As with many issues in this strange new world of estate planning, the standard definition is no longer likely to suffice.

SPRAY TRUSTS: YEA OR NAY?

As part of a typical long-term trust, most drafters include standard spray provisions, providing the trustee with discretion to distribute ("spray") the income and principal among the entire class of beneficiaries, in either equal or unequal shares. This approach grants the trustee maximum flexibility by allowing those beneficiaries with the greatest needs to receive assets, while avoiding the distribution of assets to beneficiaries not in need of them. The flip side to this flexibility, particularly in this changing world, is concern amongst beneficiaries regarding the fairness of such broad discretion. Those beneficiaries who need less may come to resent their inability to share equally in the trust's income because of their personal success or lack of financial or personal crisis. And even those beneficiaries with clear needs may resent the trustee's discretion if the trustee determines that a distribution in the amount requested is not appropriate.

From a drafting perspective, these concerns should give drafters pause. The very flexibility that would seem to be the hallmark of long-term trust design now may also be its undoing. Drafters may want to reconsider the terms under which distributions can or should be made and the extent to which such distributions should be in the trustee's discretion. For a long-term trust, there may be a good reason for making income distributions mandatory (at least after the beneficiary has reached a stated age, such as 21, or a given milestone, such as college graduation or its equivalent), and restricting principal to very clearly defined areas, such as medical, health and education needs. This narrow standard for principal distributions likely will allow the trust to last for a longer period of time and also may reduce potential conflicts over its terms.

For a long-term trust, there may be a good reason for making income distributions mandatory.

ONE FOR ALL, OR ONE FOR EACH?

A closely related issue to the use of spray trusts is the decision whether to retain all assets in a single trust or create separate trusts for either each family branch or each beneficiary. While the use of a single source can allow for more efficient investing and reduced expenses, it oftentimes can feed the resentment of beneficiaries regarding the share(s) received by others. In addition, a single trust requires that all beneficiaries receive statements, thereby making each beneficiary aware of the varying needs of the other beneficiaries. This lack of privacy, ultimately, may lead to additional issues and resentments.

The use of separate trusts, however, presents its own challenges. As the size of the family increases through the generations, the size of the individual asset pools will decrease, and soon they may become so small as to be uneconomical to administer. Investment options may be restricted as well, since the smaller sizes of the separate trusts will make some investment vehicles impractical at best.

Beyond these administrative considerations, the decision between a single trust and separate ones often will represent clients' differing philosophies on the use of this wealth by future generations. Some individuals, for example, may see the family wealth as a collective resource to be used by different members of the family on a need-by-need basis. Under this view, there is no "right" to any share of the assets, and if there are unequal needs, there should be unequal distributions.

The contrary view is based on a belief that each beneficiary has his or her own share in the wealth, and therefore, some autonomy regarding its use. For instance, if a beneficiary has needs, the assets are available to request, and in the absence of such a need, the funds remain available to supplement that beneficiary's own assets or provide an even more comfortable lifestyle. The view held here is that each beneficiary should have equal access and equal distributions, regardless of need.

While individuals' perspectives may vary, the difference between these philosophies is so stark that the grantor must decide which method fits with her values and goals to assure the plan is properly drafted. In either event, the document should reflect that philosophy clearly in order to avoid future conflicts and issues.

DECISIONS MUST BE MADE

In the end, every grantor will need to determine what is most important in creating a long-term trust – flexibility or defined standards. If the goal is to have a trust with clearly defined goals and intentions, a large amount of flexibility may be inappropriate. However, if the intention is to allow the trust to change over time, even in ways the grantor may not have anticipated or approved of, the document will need to be drafted accordingly. As with so many of the issues discussed, this ultimately is a decision the grantor will need to make. Northern Trust stands ready to assist in these conversations and to work with grantors and their advisors to help implement those goals.

"Changing Conversations" is a series of articles authored by Northern Trust thought leaders from across the country intended to present unique perspectives on the new trends and approaches to wealth transfer planning resulting from the myriad of recent tax law changes. Our goal remains to provide fellow advisors with our best insights on topics – some familiar, some not – and to foster and enrich new conversations with clients as we work together to chart a course through often unfamiliar waters. Please contact us to continue the discussion offered in any of these pieces or to provide your feedback.

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